

Realty Trust Review

For delivery March 29, 1971

VOL. II, No. 3

TRUST SHARES FOR YOUR ATTENTION

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PLENTY OF ACTION IN THE TRUSTS

The trust stocks have been among the standout market performers in past months. Hence, it was no surprise when the week of March 19 ended, five of the thirteen trusts listed on the New York Stock Exchange were on the new high list. Most important, however, is the general fundamental justification and still reasonable evaluations. Many trusts are well situated to finance many aspects of the rapidly growing construction market and are developing new techniques to do so. Granted, some aspects of the environment are becoming less favorable, namely greater competition. The offsetting plus is declining borrowing costs. Together these are making for considerable changes in the trust community. Opportunities and difficulties are going to make themselves felt more. Those that are going to be successful in obtaining larger market share are likely wearing buttons on each lapel: Origination Power and Borrowing Power.

Additionally several trusts are going beyond the usual fundamentals of straight financing by heavily leveraging and soundly lending. More are becoming sophisticated and imaginative real estate participants in the full sense of the word. Two such covered herein are Diversified ~~and~~ Realty Income Trust. Further evolution and more innovations are on the way.

KENNETH D. CAMPBELL, EDITOR AND PUBLISHER / AUDIT INVESTMENT RESEARCH INC., 230 PARK AVENUE, SUITE 555, NEW YORK, N.Y. 10017 (212) 725-1410

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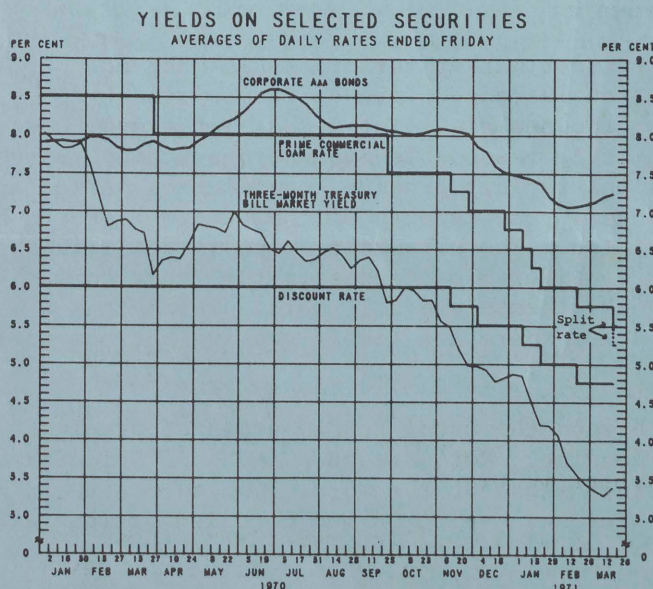
SHORT TERM RATES BOTTOMING, LONG-TERM RATES STILL MOVING DOWNWARD

We believe you can expect short-term interest rates to start showing some stabilization in the months ahead. The big move of the prime rate to $5\frac{1}{4}\%$ over the past two weeks, down $\frac{1}{2}\%$, was long overdue because other short-term rates--Treasury bills, commercial paper--had already sagged below 4% and were approaching 3%. Some correction in the prime rate was inevitable.

But the fact that major bankers couldn't agree for over a week on the new level probably signals the end of this downward leg in the short-term markets. This eight day period of split rates was the shortest on record. But note that split prime rates have occurred only twice before in the post-war years. From late January to late March, 1967, the banks split at $5\frac{1}{2}\%$ - $5\frac{3}{4}\%$, with the lower rate prevailing. In six weeks from September to November in 1968, they split at 6% - $6\frac{1}{4}\%$ before the higher rate became general. The prime then moved up to $8\frac{1}{2}\%$ within little more than seven months.

Both times dissension marked the end of a major trend or start of a new one in all interest rates. Indecision on the prime isn't infallible as a money market indicator but neither can investors dismiss the significance of split prime rates in the past.

Worth noting too is that the prime has now dropped below the bottom established in the 1966-67 easing in the credit markets. This puts it back more nearly in line with the first half of the 1960s and if we are correct, there is every possibility the first half of this decade will be more like the first half of the 1960s than the last half. In other words we do not presently look for such convulsive changes in the money market as we have witnessed in the past two years and especially in recent months (see chart).



First quarter economic indicators were sluggish by and large, with the notable exception of housing. This means that the economy is responding very slowly to the Nixon Administration's style of expansionary policies. We read this to mean that short-term rates are in for an extended period of sluggishness, perhaps extending into early 1972.

Long-term rates, on the other hand, are vulnerable to further declines. The chart points out the yawning difference that has now opened between short-and long-term rates. The last time this happened, in late November, it presaged a fall in long-term rates that ran to

75-100 basis points (hundredths of a percent) generally, with both short-term investments and some consumer interest rates paid by thrift institutions falling. This situation has in the past caused investors to seek the higher yields available in the long-term market, thereby driving yields down in that market too. Further,

the January and February declines in the consumer price index--to an annualized rate of 1.8% from the 4.5%-6.0% and up rates of the past two years--provide some comfort to long-term investors that they can safely re-enter the long-term market.

On balance we look for long-term AA-rated corporates to be in the 6.55 range by mid-summer and the FHA rate (now 7%) at this level too. Some banks and savings and loan associations may be a bit lower, notably in New York and California where the money glut has been most noticeable.

All this means share prices of financial-type mortgage trusts should have some further appreciation head. Our investment policy is based upon capitalization of trust dividends. If our projections of interest rates are correct, then the shares of long-term mortgage trusts (see RTR, March 1) have more upside potential over the near-term than short-term trusts.

The movement in short-term trusts should be more diffused over the list because with the present scarcity of short-term loans not all trusts will be able to originate loans to fill their portfolios and perhaps expand their leveraging equally. Before this latest round of prime-rate declines, the bulk of new commitment for one major trust, for instance, were at 4% over prime with a minimum of 10%. The best loans were 3½% over prime with a 9% minimum. As yet these have not changed much since the prime drop. Portfolio yields of short-term trusts are obviously well above these levels but likely will decline as loans are repaid. Since money costs fall quicker than portfolio yields for these trusts, their spread is widening. But the gut question is whether individual trusts can leverage enough to offset the impact of falling portfolio yields. Our portfolio selections (below) in this area concentrate upon trusts we believe have demonstrated superior originating and leveraging capability.

Equity trusts will likely respond a little more slowly to the changing money market tides but should move more nearly in line with the long-term mortgage trusts. There are some interesting values in this group as newer managements seek to accelerate growth of some older trusts and new trusts enter the market with more aggressive growth ideas.

As always we believe shares of short-term mortgage trusts should be bought based on projections of no more than one year, while the time horizon can be expanded for long-term mortgage and equity trusts.

SHARES OF TRUSTS SUITABLE FOR CURRENT INVESTMENT

no

Changes since our March 1 listing include addition of Great American Mortgage and Unionamerica Mortgage to the rapid growth list, Republic Mortgage, Beneficial Standard Mortgage and Goodrich Investors to the high-dividend list, U.S. Realty Investments to the partially tax-sheltered list, and Citizens Mortgage and Wells Fargo Mortgage to the list of trusts selling below book value.

In the rapid growth list, Larwin Mortgage is still selling relatively close to book value of \$18.79 per share and current prices do not appear to reflect the leveraging capability building in this trust. Shares of the aggressively managed Chase Manhattan trust are probably ahead of themselves and should be bought only on reactions.

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Rapid growth and appreciation potential

Associated Mtg. Investors
 Chase Manhattan Mtg. & Rl. (Sept. 24)
 Continental Mtg. Inv. (this issue)
 First Mtg. Inv. (also wts.) (Nov. 25)
 Guardian Mtg. Inv. (Dec. 28)
 *Great Amer. Mtg.
 Larwin Mtg. Inv. (Aug. 21)
 Midland Mtg. Inv.
 Mtg. Inv. Grp. (chng. to Cont. Ill. pending)
 North Amer. Mtg. Inv. (Sept. 24)
 *Unionamer. Mtg. & Equity

Longer-term, stable growth-mortgages

Barnett Mtg. Tr. (Dec. 28)
 Amer. Fletcher Mtg.
 C.I. Mtg. Group (Aug. 21)
 Conn. Gen. Mtg. & Realty (Mar. 1)
 *Diversified Mtg. (this issue)
 Galbreath Mtg. Inv.
 Medical Mtg. Inv. (Feb. 1)
 MONY Mtg. Inv. (Mar. 1)
 Sutro Mtg. Inv.
 Wachovia Realty Inv.
 *Newly added to list

Growth through equity holdings

First Union Real Estate
 General Growth Properties
 Pennsylvania Real Estate
 Real Estate Inv. Tr. of America

Above-average current income

Allison Mtg. Inv.
 American Century Mtg. (Dec. 28)
 *Beneficial Std. Mtg. Inv.
 *Goodrich Investors
 Palomar Mtg. Inv.
 *Republic Mtg. Inv.
 Riviere Realty Trust

Partially tax-exempt dividends

First Union Real Estate
 Franklin Realty
 *U.S. Realty Investments
 Washington Real Estate

Recovery from discounts to book value

*Citizens Mtg. Inv.
 Mobile Home Communities (Feb. 1)
 Wells Fargo Mtg.

FROM THE MEN WHO GAVE US THE MORTGAGE TRUST, ANOTHER UNFOLDING CONCEPT

Perhaps the biggest casualty of the 1969-70 proliferation of short-term mortgage trusts was the trust that everybody looked upon as the pattern for short-term trusts. We refer of course to Continental Mortgage Investors, which will wind up its ninth full fiscal year this week with earnings of about \$1.08 per share. That's an astonishing 31% compounded annual growth rate over its life, a rate that puts CMI in the top ranks of all companies listed on the NYSE.

Yet the proliferation of competing vehicles for investment dollars has cut CMI's once-lofty P/E ratio that had reached 36 times earnings down sharply. The stock price slid sharply from a high of 24½ touched down briefly a year ago to 12½, where its P/E was still somewhat above the pack of new trusts. Lately the issue has recovered strongly and now is trading at about 21 where its price/earnings ratio of about 19 times annualized earnings is still well above the group.

But a year and a half ago, when new trusts were coming on stream with gusto, Continental management, M.J. Wallace and the group he had assembled, sponsored a new trust to invest in intermediate term mortgage and equity investments. Diversified Mortgage Investors arrived on the scene in September 1969 and immediately had a runup in its stock price. Then it fell along with Continental, plunging from 31½ to 18 1/8. DMI shares have also now recovered significantly.

Both trusts now appear to have some very interesting potentials and are worth investing in even at today's advanced prices.

Continental Mortgage Investors is closing the books on what may be one of the most difficult quarters in its record. Heavy repayments of some major loans during the quarter--most had been scheduled--reduced the gain in investments to about \$15 million for the quarter, vs. an average of \$22.5 million over the preceding year.

At Dec. 31 the portfolio of \$335.5 million (before loss reserve) was about 17% in FHA-VA permanent loans, 82% in short-term construction and development loans, and 1% in warehoused FHA-VA loans. The short-term sector was split about half and half between construction and development loans, but management believes the development loan side may go up a bit over the coming year as builders and developers initiate new projects in response to easing credit. Since development loans command higher rates, this could keep portfolio yield from eroding quickly.

New construction commitments are in the 9½%-10% range and CMI full intends to remain competitive. Portfolio yield stood at 11.6% in the December quarter, still among the highest for short-term mortgage trusts, and probably declined by 20 to 30 basis points in the March quarter. For the next three quarters we believe the projected loan mix could result in another decline of about 0.1% per quarter, probably bringing overall yields down to 11.0%. After that the environment we project indicates rising portfolio yields.

We expect the portfolio to return to its average \$22.5-\$25.0 million quarterly gains after the current quarter, so that the portfolio should approximate \$450 million at the end of CMI's fiscal 1972 (March 1972).

On the liability side of the balance sheet, CMI seems ideally suited to take advantage of the money market we project. The trust switched from dealer to direct placement of commercial paper during January and is currently selling paper in the 3 3/4% area for 30-90 day loans. The overall commercial paper outstanding of about \$100 million is costing about 5% effectively. CMI has about \$173.4 million of long-term straight and convertible debt outstanding with an average interest cost of 5.6%, among the lowest of any trust, and while this rate is obviously favorable, falling portfolio yields act to squeeze the margin on these borrowings.

In conjunction with this switch, CMI renegotiated its bank lines to get a 10% compensating balance on back-up lines plus 10% on the used portion. Bank lines were increased from \$85 million to \$185 million, which effectively gives CMI the financing it needs to reach the goal of a \$450 million portfolio within one year with no additional financing through either convertibles or sale of shares.

On this basis we estimate that CMI earnings per share were about \$0.29 in the March quarter and should advance fairly steadily to about \$0.36 per share in the March 1972 quarter. Our estimates indicate earnings per share of about \$1.32-\$1.35 per share fully diluted in fiscal 1972 (ending March), vs. the \$1.07-\$1.08 we expect for fiscal 1971. This implies a 24%-26% growth in EPS for the coming year, a rate we caution is slightly higher than the 20% management is willing to concede.

Continental's balance sheet (see statistics) is gradually starting to show effects of conversion of \$123 million of convertible debt. In January \$42.0 million of its 5% convertibles were converted and the remainder of \$38 million likely will be converted into 1,888,000 shares (at \$20.125 per share) after the April interest payment. The \$85 million of 6¼% convertibles, offered in February 1970, probably will be converted (at \$22.25 per share) over the next year into 3.82 million shares. When fully converted, Continental will have 21.06 million shares with book value of \$9.73 outstanding. The earnings picture we project probably reflects the fall-back of CMI's growth to a more sustainable rate of 20%-25% annually. While the annual rate is down, we believe the increase will be handsome indeed compared to the great majority of short-term trusts which may be hard-pressed to show any gain at all. Moreover, Continental still has the operating record giving it capability of

getting future debt issues rated by the major rating agencies (which require a five-year history for ratings). At present prices CMI shares are still trading at 120% over converted book value to yield about 5.0%. This gives the trust a big advantage in raising cheap money in the future. Although richly appraised, the shares should make further progress over the intermediate term.

CONTINENTAL MORTGAGE INVESTORS (CMI)

Year ends March

	Earn/sh.	Div.
1968	\$0.38	\$0.37
1969	0.50	0.50
1970	0.75	0.725
1971	E1.07-08	E1.00
1972	E1.32-35	E1.25-30

CAPITALIZATION (12/31/70) (Mil.\$)

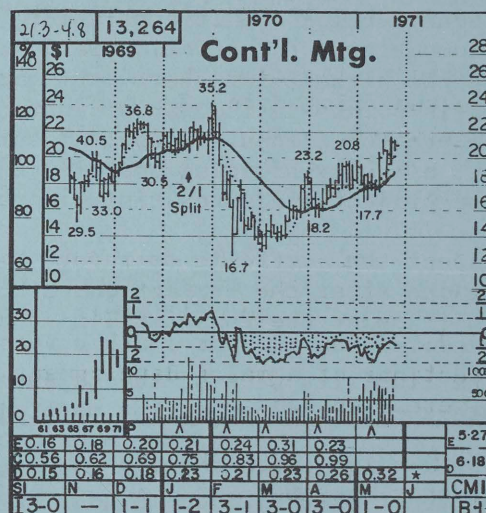
Short-term notes	\$101.1
Long-term straight debt	50.4
Convertible debt	123.0
Equity (15.35 mil. sh.)	81.9
Total assets	\$371.0

Recent price: 21 3/8

Book value (converted): \$9.73

Leverage to capital funds: 0.74-1

Chart courtesy R.W. Mansfield Co.



Diversified Mortgage Investors probably bit off more than it could reasonably chew when it first came into being and was thus a disappointment to early investors. Some background is in order. When DMI was first offered, it was thought to offer a low-multiple way to buy the Continental management (the top officers of the two trusts overlap) and the stock attracted a big following. But many early investors soured when the initial investments in construction and development loans proved very difficult to roll over into higher yielding investments.

Too, the trust had to build an operating management to carry out the policy directives of trustees. With other trusts in the personnel market at the same time, this proved to be slower than anticipated. When quarterly earnings failed to zoom, investor disenchantment followed.

Now however we believe Diversified represents one of the most interesting values in the trust market today and probably finally justifies that early enthusiasm for buying Continental management at a low multiple.

Diversified is making steady progress in putting substance to an investing concept that is still very much misunderstood. For DMI is developing into a specialist in three relatively arcane areas of realty lending: 1) recreation homesite loans, 2) land acquisition loans and 3) short-term fully amortizing standing permanent loans.

Because about \$25 million of those original short-term construction loans remain to be rolled over by the end of June, the portfolio of about \$145 million is just now rounding into the shape envisioned by the architects of its investment policy. This leaves about \$120 million (our estimate as of March 31) in loans reflecting the three objectives. Of this amount, about \$5-\$10 million are

in the short-term standing loan category, and we estimate about \$70 million are in recreation homesite loans and \$30-35 million in land banking loans.

Recreation homesite loans are originated from recreation community developers and may involve either purchase of single loans to ultimate buyers at discount or a single over all mortgage with both individual loans and the unencumbered land pledged as security. Most loans have a seven-year term but are probably repaid in shorter periods when lot purchasers begin construction. Yields are believed holding in the 11%-plus range for these loans.

Land acquisition loans are primarily to facilitate land banking by developers operating in the fringe areas of major metropolitan areas. In most instances the trust wants some assurance of reasonably rapid development--say three to five years. Here too the trust can command yields well above those for land development and it is possible to get some equity participations for the trust.

Short-term permanent loans, or standing loans, are generally standby loans on improved property that is awaiting final funding of its mortgage from either a permanent lender or from DMI itself. In some instances the permanent lender has not scheduled funding for another year or so; in other instances the loans may cover sections of a major development like a shopping center that will be built in several sections.

DIVERSIFIED MORTGAGE INVESTORS-DMG Year ends December

Quarter	Earn/sh	Div.
Dec. '69	\$0.38	\$0.36
Mar. '70	0.40	0.37
June '70	0.43	0.39
Sept. '70	0.47	0.42
Dec. '70	0.54	0.51e
1970	\$1.84	\$1.69
1971	E2.45-2.50	E2.40

e-Plus extras

Capitalization 9/30/70

Convertible deben. \$24.8
Equity (6.33 mil.sh.) 123.2

Recent price: 27¼

Book value (converted): \$19.98

Leverage to capital funds: 0.0-1

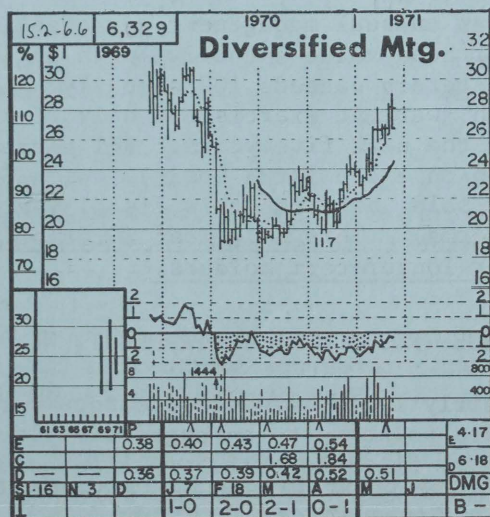


Chart Courtesy R.W. Mansfield

So far interest rates on DMI's three specialty areas have not eroded nearly as quickly as in the short-term construction sector. Thus DMI has the capability of continuing to increase portfolio yield over the intermediate term. Moreover, DMI, is large enough to become a specialist in not one but three areas of realty lending. Thus if one sector--say recreational loans--becomes competitive, investments can be shifted to other areas.

The other plus is DMI's unleveraged position. There are now only about \$14 million of those convertibles out and they should be converted before long. The trust appears to have capability to leverage through commercial paper using the Continental format. The trust plans to pay essentially 100% of earnings in dividends, with extras from a year carrying forward into the first quarter of the following year. The shares are moderately priced at about 12.5 times earnings and an 8.0% indicated dividend. When the

unique character of DMI becomes better known, we expect a significantly higher market value.

REALTY INCOME TRUST ACCEPTS SOME DILUTION TO SPEED GROWTH

Shareholder of Realty Income Trust (about 14 $\frac{1}{4}$ -ASE) have just voted to accept dilution in book value in return for the opportunity to speed its growth. Formerly known as Sixty Realty Trust, RIT was sponsored by the group of pension funds affiliated with Textron. While shares were publicly registered, the trust didn't receive public notice until a combined primary and secondary offering of 650,000 shares in June, 1969. Until now RIT has operated without a management company.

Now in an unusual transaction RIT has retained Westminster Properties, a subsidiary of the one-bank holding company owning Rhode Island's largest commercial bank, as its new investment adviser. Westminster's parent, Industrial National Corp., at the same time will buy 300,000 shares of RIT at \$10 per share and sell to RIT \$3 million of branch banks to be net leased to RIT at a 10% yield.

Since RIT's 1,216,000 shares had a \$14.09 book value beforehand, the transaction will effectively reduce book value to \$13.29 per share. The share price was negotiated at a time when RIT shares were trading at 11 $\frac{5}{8}$, with the discount reflecting Industrial National's investment position in its approximate 20% interest in RIT.

Under an unusual management agreement, Westminster will work for a management fee of $\frac{1}{2}$ % of book value annually, with an incentive of up to 25% of the amount by which trust return exceeds 10% annually. In addition, Industrial National receives a 100,000 sh. warrant exercisable only if RIT earnings per share advance by 10% annually over the next five years. RIT earned \$1.37 in fiscal 1970 ending last April 30 (or \$1.06 on a pro forma basis). With \$0.25 capital gains from a recently approved land sale, earnings this fiscal year could be about \$1.40 per share (or about \$1.10 pro forma). This is a most interesting change of management which should work out well for longer-term holders.

TWO INSURANCE TRUSTS MAKE THEIR DEBUT, NEW FILINGS BY OLD TIMERS BUILD UP

Two fairly large initial offerings were made. Additionally, registrations by existing trusts point up to an aggressive leveraging round by some established trusts. Sutro Mortgage filed for \$12.5 million convertible debentures with warrants to purchase 250,000 shares and Atico Mortgage filed for \$15 million in convertible debentures with warrants to buy 300,000 shares. Offerings:

Gulf Mortgage and Realty Investments will invest primarily in long-term mortgage loans and equity investments. It intends to invest frequently in mortgages with participations. A subsidiary of Gulf Life is the advisor and the trust will have the opportunity to invest in at least 50% of each of the insurance company's investments. The trust raised \$40 million equity with warrants attached to purchase another \$40 million. Leo Brinkley, Jr. is president of the advisor. Address: Gulf Life Tower, Jacksonville, Florida 32203.

Northwestern Mutual Life Mortgage and Realty Investors will invest in mortgage loans and equity with the major portion being in long-term mortgages. The advisor is Northwestern Mutual Life Insurance with a loan and equity real estate portfolio of \$2.27 billion. The offering raised \$100 million equally divided between equity and convertible debt. E.F.E. Furguson is president of the advisor. Address: 250 Boylston St., Boston, Mass. 02116.